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Smart Ways to Boost Your 401(k)

These seven steps will help you build your retirement nest egg.

By Jane Bennett Clark, From Kiplinger's Personal Finance, March 2013

Ah, for the days when employers worried enough about your old age to set aside and invest money on your behalf, assuring you of a secure—or at least sustainable—retirement.

Actually, employers still worry about your old age, but now they mostly use your money, plus the power of inertia, to get you where you need to be. Companies are not only automatically enrolling employees in 401(k)s—the pretax accounts that have mostly supplanted pensions—but they are also choosing employees' investments and boosting contributions on an annual timetable. You can decline to participate, but most people don't, either because they don't get around to it or because they like the results.

The approach seems to be working. Over the past five years, the percentage of employees participating in a 401(k) or similar defined-contribution plan has held steady at 77%, according to the Transamerica Center for Retirement Studies, despite the bear market of 2007–09. And account balances have risen, from a median of $74,781 in 2007 for the baby-boom generation to $99,320 in 2012.

If you're like most people, you still need to save harder and longer to accumulate enough for a secure retirement—say, for an annual income that replaces 75% to 85% of your final pay. And 401(k)s keep evolving (see IBM Sets a Stingier 401(k) Standard). So, rather than letting your employer make all the decisions, get the retirement you want by following these seven steps.

1. Beef up your contributions. Concerned that employees aren't saving enough for their retirement, Congress has authorized employers to automatically enroll workers in the company 401(k) and peel off 3% of their pay (gradually rising to as much as 6%) for the plan. Now 56% of plan sponsors use auto enrollment, up from 44% in 2010, reports the Defined Contribution Institutional Investment Association.

Automatic enrollment helps get procrastinators off the dime, but it can also send a message that a contribution rate in the low single digits is enough to create a comfy nest egg. Rather than be content with a 3% to 6% salary deferral, you should be setting aside at least 10%, up to the annual max ($17,500 for 2013 and, if you are 50 or older, another $5,500 as a catch-up contribution), says John Killoy, of Transamerica Retirement Solutions, which designs retirement plans. "If you reach your thirties and haven't saved a lot, you'll have to look toward 15%. If you're 50 and haven't saved much at

all, you're going to have to be much more aggressive than 15%."

In the real world, most participants contribute far less; the median contribution is 7%, according to the Transamerica Center for Retirement Studies. If nothing else, at least contribute enough to get the full company match. "It's company compensation," says Killoy. "You've earned it. By not meeting the match, you're leaving money on the table." Then try to ratchet up your contribution by another percentage point a year.

2. Consider the mix. Companies offer 19 choices, on average, in their 401(k)s, but the number can go as high as 70 or even 100—a selection that can be "overwhelming" to would-be participants, says Killoy. Some companies are cutting back on the fund offerings and adding brokerage windows so investors who want more choices can trade outside the plan.

Whatever the menu, you'll likely see actively managed domestic and international stock funds and bond funds as well as at least one index fund and a money market fund. Most plans also offer a series of target-date funds, which start with mostly stocks and ease into bonds and cash as they get closer to the target date.

The general rule is to load up on stocks while you're young and have time to weather a few market downturns, and move to less-risky investments over the ensuing decades. "If you're in your twenties and have a relatively high risk tolerance, you could be 90% in stocks, with a 10% bond weighting," says **Gil Armour, a certified financial planner in San Diego**. "Someone who is very close to retirement should have a portfolio of about 50% stocks and 50% bonds."

3. Go with a target-date fund. If you don't designate your own investments, the law lets firms pick one for you. The three kinds of investments they can offer with immunity from liability (that is, you can't sue if you lose money with the company's choice) are: a series of target-date funds, a fund that offers a static blend of stocks and fixed-income investments based on your risk preference, and a managed account, in which investment professionals tailor your portfolio for you. You'll receive a notice of your right to select your investments yourself. The default kicks in if you fail to do so.

Each option offers you a diversified portfolio. But target-date funds have become the investment of choice not only for employers, as a default, but also for experienced investors who like the convenience. "It's a no-brainer type of investment," says Armour. "You can stick with it into and through retirement—as long as you understand the mix."

That's a major caveat. Target-date funds generally allocate 85% to 90% of their assets to stocks in the early years but vary widely in their stock allocation as they approach the target. For instance, Morningstar reports that funds with a 2015 target date range from 20% in stocks to as much as 78%. Don't find out too late, as many investors did in 2008, that your fund leaves you more exposed than you care to be.

Funds also differ in how they define target date. Some set the end point at or near your actual retirement; others continue to adjust the allocation for several more decades, keeping the balance more heavily weighted in stocks over a longer period. If you prefer an aggressive approach, pick the fund with an end point that extends past your retirement date. For a more conservative mix, go with one that stops the clock at your retirement or before.

4. Watch those fees. Last summer, you should have received a statement from your plan administrator that listed plan investments and their performance, the types of expenses that can be deducted from your account, and the oper-ating expenses for each investment (see Decoding Your 401(k) Fees). That was followed by another statement spelling out which fees you rang up yourself—say, for setting up a loan.

Fees can have a dramatic effect on your retirement savings, so if you tossed the statements in a drawer, fish them out. You can get an idea of how the overall fees for your plan compare with those of like plans at other companies by going to Brightscope.com. If you don't like what you see, talk to your plan manager about making changes. As for the fees for your particular investments, you might discover that another investment among your options costs less and has turned in comparable returns or better. In that case, it makes sense to switch.

5. Save in a Roth 401(k). If your company's 401(k) plan offers a Roth option, you have a tough decision to make. As with a Roth IRA, a Roth 401(k) involves trading a tax break today for a tax break in retirement. Salary you steer into a Roth account is not pretax. If you contribute $1,000 a month, your take-home pay really goes down by $1,000—not the $750 it would cost you to contribute to a traditional 401(k) if you're in the 25% federal tax bracket (or less if you're also avoiding a state income tax). But the payoff is sweet. Inside the Roth account, all earnings are tax-free, not simply tax-deferred. Assuming the account has been open at least five years, withdrawals in retirement are tax-free.

If you expect to be in a higher tax bracket in retirement, a Roth is sure to be a winner. You pay tax on deposits at a lower rate than you'd owe on the withdrawals. If you expect to be in a lower bracket, or you need the tax break now, the Roth account becomes less tempting. But keep in mind that the more taxes you pay upfront, the more money you'll have to spend as you please in retirement.

Choosing the Roth is not all-or-nothing. You can divide your contributions between traditional and Roth accounts in any way you like and change the mix at any time. If your company matches pay-ins, those funds automatically go into the traditional account.

Early this year, Congress greatly expanded the opportunity for workers to convert all or part of their traditional 401(k) account to a Roth 401(k), if their company offers the option. As with IRA conversions, the price of admission is the tax you'll pay on every dollar you move to the Roth.

6. Build your own pension. When you retire, you have the option of using some of your 401(k) assets to purchase an immediate fixed annuity to provide a steady income. Now, some employers are offering an annuity within their 401(k) that protects your savings in the years before retirement and guarantees lifetime income after you've retired.

With an immediate fixed annuity, the monthly payout is based on how much you put in—say, $100,000—at the time you buy it. With the newer annuities, known as guaranteed lifetime withdrawal benefits, you would invest that $100,000 in an insured product—typically, a target-date fund—that guarantees a base amount from that point forward. The guaranteed amount is your $100,000 buy-in plus contributions you make later and any earnings on your investment, minus expenses. The base amount can go up, but it never drops below the high-water mark in the years before you retire, even if your investments do poorly.

You'll pay for that peace of mind. The cost of the guarantee—perhaps 1% of your balance a year, plus investment expenses—means the guaranteed amount won't grow as fast as the same amount in an account without the guarantee. And the annual payout—about 5% of the balance—is less than that of an immediate fixed annuity, currently 6.6% for a 65-year-old man.

The big advantage to these deals is that they protect you from precipitous drops in the stock market in the years immediately before you retire, says Steve Vernon, author of Money for Life (Rest-of-Life Communications). The trade-off is that the cost of the guarantee will eat into your returns. And although the payout is locked in at retirement, the income base goes down as you withdraw the money, so to produce a higher payout, your returns would have to exceed the amount you withdrew plus the expenses.

If you care more about protecting a chunk of your retirement savings than the impact of expenses, go with this type of annuity, or split the difference by guaranteeing just part of your savings. Don't jump into this complicated product without getting expert advice.

7. Educate yourself. Depending on your employer, you might get a slim pamphlet explaining your 401(k) plan and its investment options, or you might get access to everything from investment workshops to one-on-one counseling to online calculators that help you set retirement goals and plan accordingly. Don't wake up at 66 and wish you'd done your homework when you were 25. Even with automatic 401(k) features and employer hand-holding, you're responsible for your own future. "This is likely to be the biggest investment account of your life," says Armour. "The correct decisions can make the difference between retiring comfortably and barely getting by."

Investing in mutual funds and annuities involves risk, including the potential loss of principal invested. Risks vary depending upon the strategy used by the fund as well as the sectors in which the fund invests. When redeemed, shares may be worth more or less than the original amount invested. Annuity guarantees are subject to the claims-paying ability of the insurance company. If purchased within a qualified plan, an annuity will provide no further tax deferral features. Target date funds are not guaranteed and it's possible to lose money at and after target date. Allocations may be modified without shareholder vote. Funds come with risks and shouldn't be chosen solely on investors retirement date.

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